Expanding Financial Services Access for the Poor
The Transformation of SPANDANA

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Abstract

The paper traces the evolution of Spandana group of institutions. At the outset we explore the background of Spandana, the motivation for the promoters to set up the organisation and how it has aggressively grown from the time it was set up. The organisation reached a stage where transformation became inevitable and this change happened in a very quick time.

As a part of the study, we examine the unique issues arising out of fund movement (in the form of debt or equity) between an organisation incorporated for public purposes and a for-profit entity that would generate profits to the shareholders. The paper examines how these two seemingly contradictory aspects could be reconciled. The structural options available and how they jell with the orientation of the promoters are examined. We examine how the organisation has experimented with various options in carrying out its financial services and trading activities. We conclude that while the current legal environment did place some constraints on how the organisation's design got determined, there were issues about the quality of governance available to the organisation during its initial years.

Spandana demonstrates that there is a huge potential for many MFIs to operate both in the urban and rural space. The fact that it could garner a portfolio of Rs. 2.4 billion in a fairly limited area and time demonstrates the size of the potential market that could be served by microfinance.

In undertaking activities at such scale, any organisation would face hurdles. This paper looks at the hurdles caused by the regulatory regime that forces organisations to take fairly circuitous routes to achieve obvious results in the organisational form. It also deals with the other services that were being offered by Spandana and how these had to be dropped due to regulatory requirements. The study concludes by drawing important lessons, raising further issues for regulation by bringing out the peculiar circumstances in which Spandana and similar organisations are working.

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M S Sriram[1]

Background

Spandana started operations in 1998 as a Non-Governmental Organisation (NGO), incorporated as a Society with focus on microfinance. The setting up of Spandana was triggered by a freak incident when the promoters then working with an NGO called ASSIST encountered a rag picker and discovered that with little financial assistance in the form of credit, a significant difference could be made in her life. At that time, though there were several microfinance institutions (MFIs) with diverse methods in reaching the poor that worked in the country, the promoters of Spandana were not aware of these models. Therefore microfinance was an exercise of re-discovering the obvious through a first hand experience. They found that this service was needed by the poor in both the rural and urban areas. Spandana started its operations like any other NGO – undertaking several developmental activities in addition to microfinance. However in about two years there was a realisation that microfinance needed greater attention and focus. Spandana then stopped all other developmental activities and became an exclusive MFI.

The initial funding for Spandana came from the Rashtriya Mahila Kosh (RMK), an Apex organisation working with retail microfinance organisations for promoting women centered microfinance in India. The association with RMK led to two things:

- The promoter was sponsored for a programme at the University of Durham. While the training itself was focussed on micro-enterprises, she got some contacts who eventually helped in raising funds for Spandana.
- RMK supported the formation of self-help groups (SHG) and their linkage with the banks. Spandana therefore started experimenting with this model.

The funding from RMK was followed by some funding from Misereor, a German agency and Caritas a Dutch agency. Later Friends of Women's World Banking India (FWWB) supported Spandana with a loan of Rs.1 million. Spandana initially implemented only the SHG model. However, as the portfolio grew, delinquencies started setting in. At that time, Spandana hired a person who had earlier worked with SHARE a very successful MFI operating in the same area. SHARE followed the principles of the Grameen model. The new employee indicated that the Grameen model was designed to have very low or no delinquencies. Spandana then decided to experiment with the Grameen model in new branches, while continuing with the SHG model in the older branches.

In two years, Spandana's microfinance portfolio grew to Rs. 5 million. Spandana's experience and operating data indicated that with an end-use interest rate cap as specified by RMK (12% per annum) the activity was not sustainable, unless there was grant funding for covering the group formation costs. This meant that Spandana had to continuously keep a grant source open. The Grameen model appeared attractive. It was easy to deliver credit through this model, the repayment rates were high due to the high level of discipline built into the groups. World over, it was accepted that the transaction costs of this model was high. This model had also proved the providing access to financial services to the poor was of greater importance than controlling interest rates.

The shift towards the Grameen model reflected a certain attitude that the promoters of Spandana had in providing financial services to the poor. The organisational philosophy was neither oriented towards getting the communities on the governance side of the organisation nor to get them as stakeholders. They strongly believed that not all activities were amenable to participatory

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methodology. They believed that provision of financial services was a specialised professional function and therefore had to be governed by independent oversight of people who were experts in this particular field, rather than buy building community stakes and community governance[2]. At the same time it was also the conviction of the promoters that profits accrued from such activities should be used for the larger societal good. They saw no contradiction in the form of organisation, the nature of activity and the structuring of residual claims (profits/losses). Possibly this was why they attempted to move from one form of organisation to another, for reasons of practicality and not for reasons of design or fit. This point will be elaborated later.

Incorporation

Spandana was incorporated as a society, registered under the Societies Registration Act XXI 1860. Other forms of incorporation were not considered at that time as it was not seen as a commercial activity. The orientation of the promoters did not consider a community owned organisation even then, so a cooperative was out of the reckoning. Even after six years of operations with aggressive growth, the promoters felt that a society was a good form of organisation to do microfinance because they thought that:

- It allowed the institution to start small, with minimal capital or small grants.
- Such an incorporation prohibited distribution of profits, and as the objectives were developmental tax exemptions could be claimed. Both these aspects allowed the organisation to plough back more resources through retentions and reach out to a larger number of poor people.
- There was no need to service investors; therefore the pressure to generate surpluses with the sole purpose of rewarding the investors was not there.
- On attaining long term sustainability, there was scope for the surpluses to be expended on developmental activities, beyond microfinance.

However, with aggressive growth, some issues became significant and caused concern. These pertained to the ownership structure. A society under the Societies' Registration Act was designed to undertake activities of public good, with charitable sources of money. When a society undertook development activities through mechanisms that were commercial, there was conflict between the form of organisation and its operations.

This problem affected not only Spandana but other similar MFIs. The issues of significance were about accountability. Though this was not an issue with Spandana at the time of this study, it still raised questions at the design level. Accountability might not have been an issue if the organisation continued to carry on charitable activities. In such a case, they would be dependent on patronage from the donor community. These agencies could potentially withdraw patronage if they found that the agency was drifting in its objectives. Therefore an external control was constantly exercised. However in case of MFIs, having received initial grants and having generated internal surpluses, the MFI was largely on its own. This happened to MFIs by design. The donors insisted that organisations achieve both operational and financial self sufficiency, and made grants to MFIs as "revolving funds". They expected the organisation to run on the basis of this corpus. However since the people running the organisation no longer expected to receive continued donor patronage, there was no incentive for them to perform according to the highest standards. It was not necessary to be self driven as their financial stakes were low, and they did not have residual claims on either the current or the accumulated income. Therefore the driving force that kept such organisations going was beyond economic rationale, not intertwined with the design of the organisation.

In choosing a particular form of incorporation, Spandana focussed on the above arguments, all of which stressed on conserving more resources to channelise them towards developmental activities. However there were also other practical issues such as ease of incorporation and regulatory

[2] Reddy, Padmaja (2005): Interview with the author on 12th January 2005.

compliances to be addressed. This helped Spandana to work unhindered and concentrate on its operations. The design elements of any organisation had to have the following elements:

- Promoters commitment was more in the intent to work for the poor, than their ability to provide risk capital
- As the activity was relatively new, the design had to be flexible so that experimentation could be done to check out the most effective delivery model.
- Autonomy, both strategic and operational was important. They sought no pressures to either make surpluses, or after having made surpluses to apply those in a particular manner. There had to be no pressure even to share the surpluses with the clients (the cooperative model). All discretion on application of surpluses (if earned) had to be with the management.
- Autonomy to invite experts on the board and therefore expand the governance base to independent professionals than restrict it to the investors.

While all these features would have been available in a not-for-profit company (like Sanghamithra[3]) incorporated under section 25 of the Indian Companies Act, it was considered to be a sub optimal option for operational reasons. The perception of Spandana was that it was difficult to incorporate a section 25 company. It was also perceived that getting a tax exemption for a society could be easier than for a company.

The other arguments laid out by the promoters against a company were that they would be unable to attract commercial investment, and that they would be governed by the requirements of capital adequacy if they were to seek borrowings from commercial sources. However, these arguments were equally applicable to a society.

Operating Procedures

Having experimented with Grameen and SHG models, Spandana introduced a hybrid model of microfinance. The operating procedures were nearer the Grameen model, but there were differences. Unlike the Grameen model, which had seven or eight five-member groups meeting at a centre with a usual size of 35-40 members, Spandana usually had around four ten-member groups a centre. The stated advantages of having ten-member groups were:

- A ten-member group brought more diversity and security, particularly because Spandana insisted that a certain number of the group members should be living in own houses. This condition was introduced to ensure stability.
- A ten-member group brought efficiency in operations. In a centre meeting, the officers had to deal with only four instead of eight groups. The transaction processing time reduced, making it possible for the officer to visit more groups than other similar MFIs in a given day.
- Spandana not only operated in rural areas but also worked in urban slums. In urban areas it was possible that all five members of a group migrating together. A ten-member group mitigated that risk.

After forming the groups, Spandana undertook basic training to convey their operating procedures. Then the groups were administered a group recognition test. If the group passed the test, they would become eligible to avail loans. In the first round the members were given loans ranging from Rs.1,000 to Rs.7,000 based on the eligibility. The loan amounts increased with successive cycles, thereby deepening the exposure of Spandana in a given area. All disbursements were done at the group meetings, in the open, and in cash. Repayments were also collected in cash. The collections were deposited in the branch office. The branch after calculating the requirements for the disbursement the following day, deposited the residual amount in a bank account. The credit officer picked up cash for disbursement for the next day from the branch before leaving for the field.

[3] Sriram M S (2004): Building Bridges Between the Poor and the Banking System: A Case Study of Sanghamithra Rural Financial Services. IIMA Working Paper No. 2004-05-02. Ahmedabad: IIMA.

Repayments were to be made in fixed weekly instalments for fifty weeks and no flexibility was offered on the repayment terms. However, prepayment of loan and accessing subsequent, bigger loan was allowed. Loans for education carried a lower interest, but the pattern of repayment was similar. The star borrower loan however had more flexibility as the repayment period extended to as long as 180 weeks.

The operating procedures of Spandana were simple and replicable. In places where other MFIs like SHARE had worked, Spandana benefited from that. They had already established norms and operating procedures. In these areas the prospective members understood the credit culture and repayment ethic. Where this environment existed, Spandana was able to set up new branches faster. But irrespective of the spade work having been done by other MFIs, Spandana brought in superior levels of performance on operational efficiency. This helped them in posting impressive results consistently.

Unlike most other MFIs, Spandana operated both in the rural and urban space. Its outreach in 2004 had a ratio of 50:50 between urban and rural on the number of clients serviced. However on loan outstandings an estimated 55% of the amounts were due from urban clients and 45% of the amounts were due from rural clients. Though an assumption would be that this mix helped to control costs, Spandana claimed that it was not so. But the loan amounts in the subsequent cycles could be higher in urban areas and therefore outstanding per branch could be higher than the rural areas. Spandana thought that this strategy was good for them in order to diversify covariant risks attendant to the rural areas[4].

Growth in Operations

In the past few years Spandana was one of the fastest growing MFIs in India. The rate of growth is evidenced by the following Table 1

Table 1 Basic performance parameters of Spandana
(Rupees in million except number of borrowers)

Year	No of Active Borrowers	Loans Disbursed		Loan Assets Outstanding	Profits	Client Savings
		Accounts	Amount			
1999-00	1,695	1,859	9.2	5	0.1	0.8
2000-01	4,358	4,942	26	13	1	2.3
2001-02	13,206	14,103	83	47	4	6
2002-03	34,095	36,768	266	153	14	21
2003-04[5]	110,010	139,374	863	557	50	65
2004-05[6]	386,035	271,182	2,063	2,389	155	138

Source: Presentation made by Spandana, December 2004, and further updates from the organisation.

Spandana grew not only due to its natural aggressiveness, but also because of an external trigger. As the figures indicate, Spandana was growing in the past four years according to its normal pace, largely dictated by its ability to raise resources from commercial banks. The banks were increasing their exposure to Spandana gradually. However, in mid-2003, ICICI Bank came up with an offer that released the constraints in sourcing funds. The proposal was to make Spandana a partner, which would lend to its client group on behalf of ICICI bank. Operationally Spandana would continue

[4] Data provided by Ms. Padmaja Reddy CEO on the basis of rough estimates and recall. This data is not verified from the records.
[5] Figures for 2003-04 and 2004 December include loans given by ICICI Bank and routed through Spandana, where Spandana was performing the function of agency. However for all practical purposes, the intensity and structure of operations was no different from the loans on the books of Spandana, and therefore they have been included in the above figures.The outstanding under the partnership model was Rs.110 million as the end of March 2004.
[6] Figures for 2004 include not only the book of Spandana society, ICICI Partnership arrangement but also the loans in the books of the new NBFC – SSIFSL. The break up of Rs. 1.358 billion is as follows: Rs. 923.9 million in the books of Spandana, Rs.405.7 million in the books of ICICI Bank and Rs.28 million in the books of SSIFSL

dispensing credit in its usual manner, but would assign certain branches as the exclusive portfolio of the bank. In the process Spandana could increase its presence and contact with clients, while not getting these loans on its own books. This would help Spandana to leverage its capital better with other lenders. ICICI Bank initially approved a limit Rs.500 million for this arrangement. This triggered competition from other banks and Spandana was able to unleash its potential. This was seen in the faster growth in the last two years.

Spandana offered five loan products: general loan, education loan, infrastructure loan consumer loans and star borrower loan for borrowers who finished five cycles. The diversification of the loans not only helped them expand geographically, but also deepen the market with existing groups. The average loan size rose from Rs.6,000 in 2002 to around Rs. 7,200 in 2004[7], even as, the number of accounts drastically increased. This was possible only due to deepening of relationship with the existing clients.

Spandana till recently offered savings services to all its registered clients. Apart from a security deposit for loans disbursed, it offered voluntary savings, and dream savings (an innovation – inviting the men to save in order to give a gift to their wives). Spandana also facilitated an auction based rotating savings cum loan product for the groups. However with operations gradually moving from the society to a newly formed NBFC, they had to discontinue savings services due to the regulatory requirements, much to the displeasure of their clients.

In May 2003, Spandana started offering consumer products to the clients. This diversification was a result of the realisation that most often clients borrowed to buy household goods and ended up paying exorbitant prices. Spandana could step in and procure these commodities in bulk, and sell them to the clients at a lower price tag.

The operating procedure for getting the consumer products was as follows: The borrower would be given a loan limit at the time of disbursal in the centre meeting. This limit could be availed in cash or through vouchers. The borrowers who opted for the voucher could exchange it for consumer goods at the store. The difference between the amount specified in the voucher and the purchase value would be settled in cash. Since the prices in the store were much lower than alternative sources, there was a huge demand for this service. Over a period of time the turnover in the consumer store grew and was around Rs.200 million by March 2005.

During the first phase of experimentation, trading activity was carried out by Spandana. However, as volumes grew, the promoter, along with some senior staff under the leadership of the CEO, set up a partnership firm. This was seen as a mechanism to give incentives for senior employees. The partnership carried out the business for around six months. However, they soon saw that there could be a conflict of interest in carrying out related activities in unrelated firms, with common individuals on the management. The partnership was therefore dissolved. The consumer business was shifted to the Spandana Mutual Benefit Trust (SpMBT). The reason for setting up this trust will be discussed later, when we talk about the issues in transformation.

Transformation to Mainstream

Spandana saw no operational problems in being a society. However external triggers made them think about moving microfinance activities to a for-profit company. A new company – Spandana Sphoorty Innovative Financial Services Limited (SSIFSL) was incorporated in 2003. Credit and financial services are regulated by the Reserve Bank of India (RBI) and a permission to operate as a NBFC was necessary. Due applications were made soon after. In 2004-05 Spandana started transferring its portfolio to SSIFSL. In this section we examine the triggers that encouraged Spandana to move to the mainstream and then examine the processes they followed.

[7] M-Cril (2004): Microfinance Rating – Risk Assessment, III Update. Gurgaon: M-Cril.

Triggers

Rapid growth brought out issues that affected the operations of Spandana. It drew the attention of bankers, investors and regulatory authorities. In an earlier paper we had identified issues that trigger the transformation/spin off of an MFI from not-for-profit framework to mainstream framework (Sriram and Upadhyayula, 2004)[8]. They were:

- Size
- Diversity of services
- Financial sustainability
- Focus of operations and
- Taxation

Some of the issues identified in the paper were relevant for Spandana when they wanted to move their microfinance operations to a NBFC. Size was one of the triggers. Spandana was growing fast and to continue at the same pace, they needed continued access to commercial funds. Over a period of four years, Spandana had attracted the attention of banks keen to provide debts. They had also attracted the attention of venture capitalists willing to invest risk capital. Spandana had visits and due diligence done by international investors such as Vinod Khosla, Lok Capital, IFC and Unitus. In order to attract commercial capital the operations has to be in a company.

With the portfolio of lenders getting diversified, there was pressure to move to a regulated environment. The banks had to justify the large exposures towards Spandana to their management and it was easier for them to explain a loan to a NBFC than to a society. Size also triggered some undue attention. For instance what should have been a normal filing of an annual return suddenly raised eyebrows, since the authorities in Guntur had not seen a balance sheet of this magnitude in a society. Suddenly the registrar would routinely issue an acknowledgement for the returns filed, wanted to study the balance sheet, before acknowledging the returns in 2004. Spandana also attracted the attention in local media, where Spandana's operating procedures and interest rates were discussed. Political risk also loomed large because of the size. Political parties had picked up interest rates on loans for the poor as a major issue in their election rhetoric. As microfinance interest rates were usually higher than banks they were particularly vulnerable. Therefore undertaking commercial lending at such a large scale in a society was seen as a risk for continuing operations. As a society, Spandana was governed by the state legislation, while as a NBFC they would be governed under the central legislation. Therefore the political risk was much lower as a NBFC.

The second and the third issues of diversity of services and focus of operations was not an immediate trigger. In fact by moving into the formal company format, Spandana had to give up savings services that it was already offering to its clients. The issue of financial sustainability was adequately addressed in the old format. The financial self sufficiency was calculated at a comfortable level of 171%[9]. Spandana had stopped receiving grant funds from the year 2002. From the microfinance operations, they were not only able to cover costs, but also post substantial margins as indicated in the Table 1 above. Focus was not an issue since Spandana was working as an exclusive MFI without other activities that could cause a strategic drift. All the other activities like the consumer shop were an extension of the basic MFI products.

Taxation was a potential trigger. There was a need to keep the corpus generated from the past operations in tact, so that it could be effectively used in pump priming the commercial arm. However, taxation for future operations was not an issue. However, Spandana still felt that such activities were better off if they were outside the ambit of the tax net so that the resources could be ploughed back.

The triggers for transformation as per Spandana (in addition to the ones discussed above) were:

[8] Sriram M S and Rajesh Upadhyayula (2004): The Transformation of the Microfinance Sector in India: Experiences, Options and Future. *Journal of Microfinance* Vol 6, No. 2.
[9] M-Cril (2004): Op.Cit.

- It would be easier to represent the organisation in public forums;
- Under the NBFC format there would be a greater accountability, as they were answerable to external investors;
- They would have access to more resources because of the interest shown by investors. This provided an enhanced base for greater leveraging; and finally
- They had to address concerns with the size and its implication on the nature and extent of liability on the members of the executive committee in case of an unforeseen problem. Though it was argued that executive committee members could not be held personally liable for acts of the society which was a body corporate, this aspect was not explicit in law, and governed by individual contracts with lenders[10]. This was an area of potential risk for the members of the executive committee.

The thought of transformation first came about to Spandana in late 2002 when the SIDBI Foundation for Micro Credit (SFMC) organised a workshop on Key Dimensions of Transformation: From NGOs to Formal Institutions. However, Spandana had to grapple with the task of legitimately moving funds that had accrued in the society as equity investments in NBFC.

Options, Processes and Issues

When Spandana wanted to transform, the options were limited. A cooperative was ruled out, as the promoters did not believe in having clients/users on the governance structure. Therefore the only option was to set up a company. Within this option, there were three sub options: To seek licence from the RBI to operate as a (a) commercial bank (b) local area bank (LAB) and (c) NBFC. The entry level capital requirements for each of these were steep. For a commercial bank the requirement was Rs. 1 billion while for LAB it was Rs.50 million. For an NBFC the requirement was Rs. 20 million. When Spandana initiated the process resources were not available to set up a commercial bank or a LAB. Even otherwise LAB was not attractive because it could operate only in three contiguous districts. In 2003, RBI took an in-principle decision not to licence new LABs. Therefore that option would not have materialised. That left Spandana with the only option of seeking a registration as a NBFC. As indicated earlier a NBFC needed an initial investment of Rs.20 million. It was not only a matter of finding Rs.20 million for investing in the NBFC, but these investments would be locked up till the licencing process was over. RBI had become stringent and their due diligence was expected to take time.

Spandana was advised that the only way of moving the money from the society was to create a special purpose vehicle (SPV) – a private mutual benefit trust (SpMBT), involving some of the members of the community. The plan in broad terms was similar to that of Sarvodaya Nano Finance (See Pathak and Sriram, 2004)[11]. The steps were:

1. To identify around 20,000 senior clients of the organisation
2. Lay down criteria for selecting these clients (this was decided as clients who had done three cycles of loans)
3. Spandana in consonance with the objects would make a grant of Rs.1,000 to each of these clients.
4. The clients in turn would voluntarily deposit the money in their respective groups.
5. The groups were then expected to pay in to the SpMBT an admission fees of Rs.100 per group and Rs.10,000 as capital fund.
6. SpMBT would in turn subscribe to the equity of SSIFSL.

Thus the NBFC would be adequately capitalised. The voting rights would be vested with the chairperson of SpMBT, who in turn would be nominated by the President of Spandana. Thereby the control of the NBFC would be vested with Spandana.

[10] The author is thankful to Ms.Shashi Rajagopalan for clarification on some issues pertaining to the liability of the executive committee members of a society.

[11] Pathak, Akhileshwar and Sriram M S (2004): Community at the Core: A Study of Sarvodaya Nano Finance Limited. IIMA working paper No. 2004-10-04. Ahmedabad: IIMA

Unlike Sarvodaya which promoted one MBT at each district level, Spandana did have such complications. The overall objective (unlike Sarvodaya) was not to have community participation in the equity investment in the NBFC as a pre-requisite, but to use the MBT as a SPV for investment of funds. This was nothing but Spandana's accumulated accruals that were being routed through a somewhat circuitous route. In preparation the deed of the SpMBT was signed and registered in July 2003. In November 2003, SSIFSL was incorporated. Soon after incorporation, the funds from the SpMBT were transferred to SSIFSL. Once SSIFSL had adequate equity, an application was filed with RBI for a permission to carry out the activities of a NBFC.

RBI has been very stringent in issuing new licences for NBFCs. RBI's due diligence involved not only the review of operations of Spandana, the promoters and their background, but they also conducted an inquiry into all related activities, by checking out with the bankers and others who had dealings with Spandana. While this process was underway, the money invested in SSIFSL could not be deployed or leveraged. The effect was that a potential of Rs. 200 million was locked up because of the process.

In February 2004 the trading activity was transferred from Sneha Enterprises – the partnership firm – to SpMBT. The rationale for transfer was evident. It appeared that private profits were made out of a related activity of Spandana, which was a public institution. While the business did not earn heavy margins, it still was a potential conflict of interest.

In April 2004, ICICI Bank came up with their new offering to ramp up the availability of credit to the poor through their partnership model. Under this arrangement, ICICI Bank agreed to give loans up to Rs.500 million in partnership with Spandana. The loans would be in the books of ICICI Bank, the products were to be packaged and delivered like Spandana products, and after undertaking to pay a certain rate of interest to the bank, Spandana could keep the residual amounts collected from the clients as commission. In addition to sourcing, appraisal, documentation and collection, Spandana was expected to absorb up the first loss of default. This proposition was attractive and they felt that the growth could be maintained while the NBFC application was being processed by RBI. As of December 2004, the partnership was operating in 20 branches of Spandana and an amount of Rs. 470 million was outstanding.

However, given the commercial nature of this activity, it was decided that this should be taken up through a company rather than by Spandana. Therefore they promoted a new company - Spandana Credit and Financial Services Limited (SCFS) in May 2004. SCFS started operations in June 2004 as a partner of ICICI Bank. Since it was only a partner, they felt that there was no need to seek a licence from RBI. However, RBI informally indicated that it would not be wise to continue these operations in SCFS, particularly when the application for an NBFC was pending from the same group, as this would be perceived as undercutting the licencing process. Based on the advise, they moved the partnership portfolio with the profits back to Spandana in September 2004. SCFS was dormant by end 2004. First the name of SCFS was changed to Spandana Sphoorty Marketing Services Private Limited (SSM). Eventually it was planned to move the trading activity from the SpMBT to SSMS, which was done in April 2005. SSM was a fully owned subsidiary of SSIFSL, thus having a complete alignment of interests.

It is evident from the above description that the process of transformation of Spandana has not been simple. It is partly explained by administrative delays and partly by the governance structure that was unable to guide the transformation in a proper manner. Figure 1 depicts as to how the structure will look when the transformation is complete.

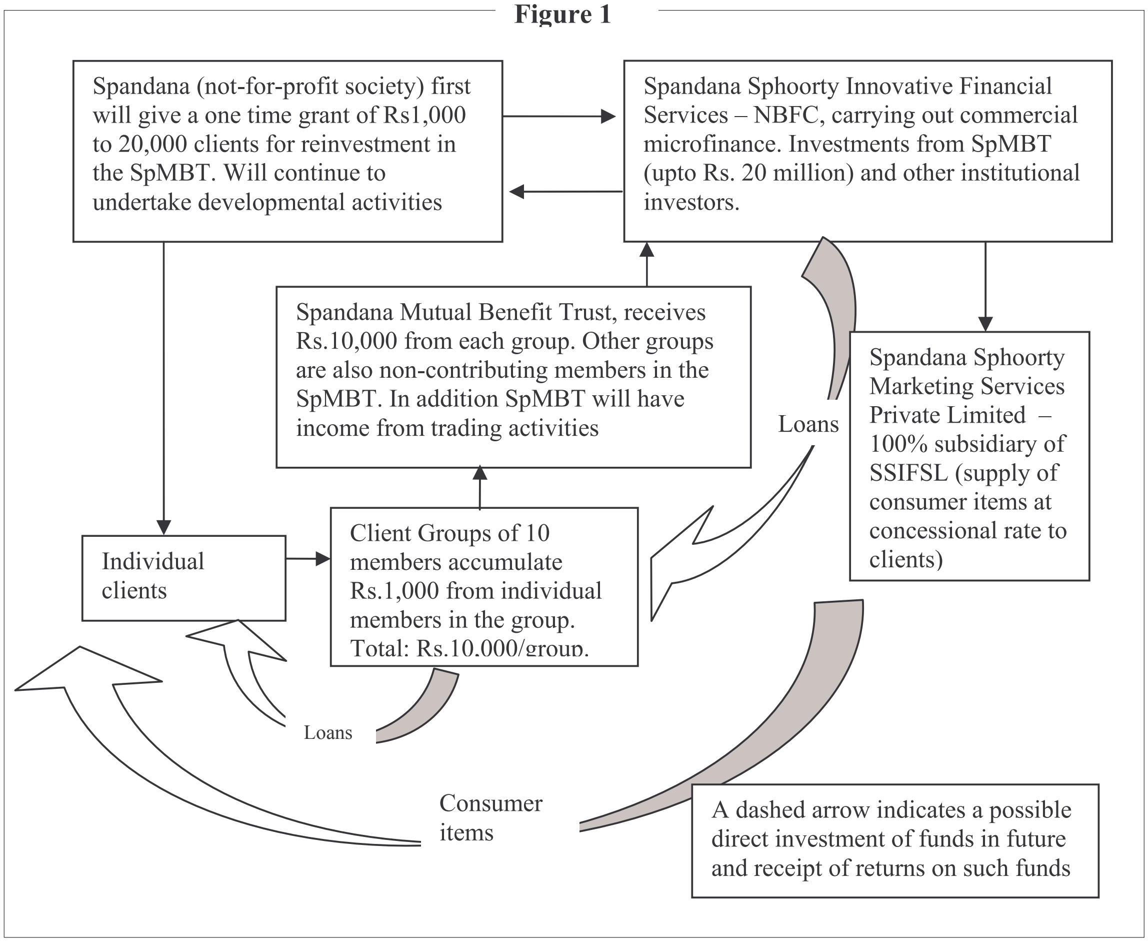
While the process of transformation was continuing, there were other issues of concern. With the SpMBT SPV, it was possible to transfer the minimum capital required of Rs. 20 million in order to get a licence to operate as a NBFC. However, as and when the entire portfolio of around Rs. 1 billion was transferred from Spandana to SSIFSL meeting the capital adequacy requirements of this scale would be a challenge. SSIFSL would need around Rs.150 million in equity and reserves. Getting this amount in place, without diluting the ownership or management control was a challenge. They were able to overcome this challenge by having almost 60% of the portfolio under partnerships with different Banks. With the budget announcement that the partnership model will be examined in detail and implemented, they did not forsee problems of capital adequacy in future.

SSIFSL had offers of equity investment from SFMC and other investors. Getting more investors would dilute control, unless the promoters concurrently increased their own investments to maintain parity. This could happen if the promoters brought in more equity from their personal resources, or if they found ways of transferring the retained surpluses from Spandana. One option that they wanted to check was whether Spandana could directly invest in the equity of SSIFSL. If this was possible, the transition could be smooth, without the fear of losing control as Spandana would have majority voting rights. However, moving money out of Spandana directly had some implications

- Whether Spandana would be recognised as a “person” under the Companies’ Act and therefore could hold equity shares and be listed in the register of members.
- Whether the Societies Registration Act permitted Spandana to make equity investments in companies.
- Whether Spandana would continue to enjoy its tax exempt status even after such an investment was made.

Spandana got a legal opinion on the implications of making direct equity investments in the company. The conclusion was that the present byelaws of Spandana does not empower Spandana to make equity investments. The firm suggested that money from Spandana be routed in the form of subordinated loan.

Figure 1



In case of the Companies' Act, while there are significant references to Trusts, including a clause that in case of Trusts, the register of members cannot contain the name of the trust, but the holding should be held in the name of the Trustees. However, the Act does not seem to have a disabling clause for societies to appear in the register of members.

It is clear from the Societies Act, that bodies registered under this act cannot make equity investments. The logic for this is that societies are charitable entities, holding funds of philanthropists in "trust". A society is seen as a means to achieve a larger societal objective, and holding investments is not the reason for its existence. It holds investments either as a short term measure in order to use the finances usefully or it holds the money as corpus, the returns of which would be used for developmental purposes. Therefore, investment in equity, which is by definition risky is not desirable and not permitted. Assuming that Spandana can indeed invest in equity and there is no disabling clause in the Societies' Act, an amendment to the bye laws enabling Spandana to make such investments would be necessary.

The tax status was a matter of debate. The tax authorities would interpret whether such investment could be termed as a "chairtable purpose". A mere investment in order to earn returns could not be seen as an activity that would define the tax status. However, if the taxation department looked as how such resources were generated, then the tax exempt status of Spandana could be taken up independently. Tax status of dividend income was not a cause for concern. Dividends were subject to a tax at the time of distribution at the hands of the company declaring dividends and tax free at the recipients' end. However if Spandana decided to invest its resources in SSIFSL as "subordinated debt" – then the tax status of interest income on such investments would be dependent on the tax status of Spandana itself.

Operational Processes

Transferring the portfolio from Spandana to SSIFSL had to be handled carefully. Various options were considered, including a one shot transfer that would take effect from 1st April 2005, so that the balance sheets of Spandana and SSIFSL could be relatively neat. However this option did not work out because too many ends had to be tied to do a one shot transfer. In most cases Spandana had to prepay loans to several lenders and simultaneously borrow SSIFSL to continue branch operations. This had to be done in a way that the clients did not feel the difference in the service at the centre. If they continued the entire portfolio in Spandana till March 2005, the portfolio size was like to hit the Rs. 2.4 billion mark (including partnership). With the Registrar of Societies getting about the returns filed in March 2004, this would unnecessarily draw his attention. Therefore it was felt that it would be better to transfer the portfolio in smaller chunks. This would also help SSIFSL to start its operations with the initial capital contribution that it had received. This move would also help in capitalising SSIFSL to retain the capital adequacy ratio.

When Spandana was debating on the mechanisms for portfolio transfer, ICICI Bank offered a securitisation deal. ICICI offered to buy the portfolio of Spandana and and pay a fee for recovering these loans. This provided an opportunity for Spandana to transfer its portfolio in smaller chunks. The proceeds of the sale would be used to prepay loans from banks, and in turn negotiate new deals from the banks. The ICICI Bank securitisation deal was used as a bridging mechanism. As of December 2004, SSIFSL was operating a total of 6 branches – three taken over from Spandana and three new branches. The portfolio size was Rs. 50 million. The sources of funds for SSIFSL were equity contributions acquired through SpMBT (Rs.20 million), and borrowings of Rs. 10 million each from FWWB, Spandana and ING Vysya Bank. The transfer was expected to be completed by April 2005, following which they would have SSIFSL doing all the financing activities, SSL doing all the trading activities and Spandana doing all the developmental activities.

In the operational processes we find that the plans have succeeded action rather than vice versa. We briefly summarise the process of moving from Spandana to SSIFSL for both the financial and the trading business as done by Spandana:

The finance business:

1. Investments moved from Spandana → Individual Clients → SpMBT → SSIFSL. (Future plans include selling the stake of the SpMBT to new investors, direct investment in SSIFSL by Spandana, ploughing back the SpMBT money to Spandana, possible liquidation of SpMBT. The resources at the disposal of Spandana to be used for developmental activities).
2. Direct portfolio moved from Spandana → Sale of part of the portfolio to ICICI Bank → Proceeds used to finance prepayment to lenders → Generate new resources in SSIFSL → start lending in SSIFSL.
3. Partnership portfolio → started in new company SCFS → Moved to Spandana → To be moved to SSIFSL in a phased manner.

The consumer business:

1. Started in a partnership firm Sneha Enterprises → Moved to SpMBT (loan from Spandana) → SSL (re-christening of dormant SCFS, will eventually be fully owned subsidiary of SSIFSL).

Future Plans

SSIFSL planned to offer integrated financial services to its clients in the future. It wanted to continue the savings products of Spandana and experiment with new products. They did not see savings as a mechanism to source low cost funds. Instead they believed that this was an essential service demanded by the client group. In the process of moving the portfolio from Spandana to SSIFSL, they had to stop savings services. Operationally this brought greater efficiency because the credit officers did not have to spend time in the centres collecting savings. Non collection of savings has also reduced the transaction load and monitoring expenses. It has also brought feedback that the clients valued these services. Unfortunately the law does not permit SSIFSL to collect savings in any form except as security deposits from clients who have outstanding amounts. SSIFSL also wanted to offer other financial services as an agent – particularly life and non-life insurance services. The consumer items currently being sold from a few locations would also expand rapidly so that significant impacts could be made in the lives of the poor. Currently they dealt with around 1400 items and wanted to expand this portfolio to meet all the needs of the clients.

As stated earlier they wanted to keep all the business segments aligned. The fact that SSMS would be a wholly owned subsidiary of SSIFSL was to take care of this alignment. Similarly they wanted to align the share holding pattern to have only promoters and institutional investors while reducing the holding of SpMBT. They were examining if Spandana could directly invest in SSIFSL. If that was permitted then, they wanted to transfer all the funds available with Spandana to SSIFSL in the form of investments. Ideally the preferred route was to take these resources as equity so that the controlling interest will be with the representatives of Spandana. However, if this was not permitted, then Spandana wanted to route these resources as subordinated debt, so that it was considered for the purposes of calculating capital adequacy. They eventually wanted to have only three entities:

- Spandana would have equity/debt investments in SSIFSL. All dividends/interests received from SSIFSL would be used for charitable causes. The first on the list of charitable causes was to set up an orthopaedic hospital in Guntur.
- SSIFSL would be the operating entity. Eventually if it was possible to convert this to a bank, that would be examined. SSIFSL would undertake all financing services – loans to poor clients, savings when permitted and insurance as an agent. SSIFSL would own SSL, the consumer arm. All trading activities will be done through SSL.
- SSMSwould run as an independent entity on commercial terms, sourcing commodities from the manufacturers and passing on a chunk of margins to the clients. It would also source commodities made by its clients if there was a market.
- Spandana has now incorporated another company called Spandana Sphoorty Chit Fund Private Limited. This is in response to the demand by the clients. The product that was being informally offered by Spandana will now be formally available. This entity will be a fully owned subsidiary of SSIFSL.

Thus, all financial products offered by Spandana Society were transferred to different legal entities making them formalised with in the available legal ambit.

Though SSIFSL was capitalised from the investments made by SpMBT, a move to transfer the shares of the SpMBT to investors was underway. As a first step, the increase in the personal stakes of the promoters was done by reducing the stakes of SpMBT. The shareholding pattern as at December 2004 was as follows: The promoters had invested personal resources and all their shareholdings together was a little less than Rs. 5 million (23% of the equity) and SpMBT had an investment of around Rs. 16.5 million (77% of equity). It was expected that institutional investors like SFMC would take a stake in SSIFSL. As and when the external investors took stake the promoters through Spandana would increase their stake accordingly to retain control.

As of December 2004 Spandana had Rs.250 million in accumulated surpluses. Of these, around Rs.100 million was in the form of margin money/security deposits placed with banks in order to get loans. Around Rs.150 million was lent out to the borrowers and remained as unassigned portfolio. These resources were available for investment in SSIFSL. This would ensure that Spandana retained control.

While the operations in its current form looked hugely profitable, the promoters perceived some risks as well as some discomfort in continuing to earn such high levels of profits. The risk was largely political. World over it was accepted that microfinance interest rates would be high. At low levels of finance it was access and not costs that was critical. However there was a heightened political attention on the interest rates charged by MFIs. Reduction of interest rates for the poor had entered into the electoral rhetoric and manifestos. Therefore there was danger of a regulatory action being initiated at the initiative of the political class to control interest rates. Spandana had demonstrated that charging interest rates benchmarked against MFIs generated huge surpluses. Though this was a result of its operational efficiency, there was a possibility of perceiving their interest rates as usurious.

Good margins were welcome in the initial years when they were on an aggressive growth path. All the retained surpluses could not in any case be distributed and therefore remained in the public arena and had the potential for both increasing access to credit to the poor as well as for undertaking charitable activities. The moment they transformed, the base equity was be from the SpMBT – a “public” source since the contributions came from Spandana society. The rest of the equity would be largely from private sources, generating distributable surpluses to investors. Spandana was uncomfortable in laying a wide base with a large profit multiplier for investors who came in later, in a format where surpluses were distributable. It therefore decided to cut margins. As a first step, interest rates were rationalised much before the first commercial investment came in so that the profitability levels were brought in to realistic levels. Generating large surpluses and then ploughing them back was no longer a desirable option. Spandana also saw the reduction of interest rates as a signalling mechanism for both the regulatory authorities and the MFIs as being a responsible corporate citizen. Effective May 2005, the board decided to further reduce interest rates.

Concerns about the current structure

While the structure they were moving towards does not look messy, concerns were about how the promoters would retain control. Spandana directly investing in equity of SSIFSL did not appear feasible as it was not likely to be treated as a “charitable activity” to come under the approved list of investments notified by the authorities. In the past equity investments were permitted in exceptional cases and those were for State supported entities like IDBI. The possibility of Spandana increasing its stake for retaining control appeared uncertain. There was no immediate concern about capital adequacy if Spandana could give subordinated debt to SSIFSL, though even that investment had to be approved as an acceptable investment by authorities. They were on a weak ground as far as increasing ownership stakes in SSIFSL was concerned.

This concern to a great extent could be addressed by not taking the loans on the books and going aggressive on the partnership or agency model. The earlier concerns about only a single bank offering the partnership model posing an issue on risk of concentration with a single partner was also overcome, because other bankers were willing to try out the agency model. The regulatory environment was also making appropriate moves to get this model due regulatory recognition.

Moving the money out of Spandana through SpMBT was something that they had tried for the initial capitalisation and they were uncomfortable about it. Moreover, as in the case of Sarvodaya, this structure raised questions on the governance structure. SpMBT was controlled through the President as the settlor. The settlor had the right to nominate the chairperson of SpMBT, who in turn could co-opt two other trustees. Two client members would be elected from the groups as additional trustees. But for all practical purposes, SpMBT was controlled by Spandana. Spandana itself was a society with independent members on the governing board. However the financial stakes of the members (not registered clients) of Spandana were limited. As grant funding was also limited, there was lesser scope for external oversight. Given all these aspects it appeared imperative for Spandana to move its microfinance operations to a regulated and accountable environment. The addition of the consumer goods business to the financial services business brought an additional dimension. However they appropriately responded by aligning this activity with SSIFSL by making the trading unit a fully owned subsidiary. The point to be highlighted here is: how does an organisation that starts its operations in the format of a public purpose organisation without any distributable rights over residual amounts, move towards a form that generates "private" profits, and while doing so, maintains the integrity of the initial investment which was charitable in nature. The method adopted by Spandana appears longwinded and complicated.

Eventually, Spandana wanted to liquidate the SpMBT. After checking with the legality of the issue, the plan was to buy out the stake of SpMBT in SSIFSL and extinguish the funds that had accumulated in the SpMBT through exactly the reverse route used in getting the funds in. If this was the plan, the implementation as of December 2004 appeared to be making this process complicated. For instance:

- The investments of the promoters to the extent of Rs.5 million that could have come in directly to SSIFSL instead of a stake purchase from SpMBT. SpMBT could have been leaner by just transferring Rs.15 million from Spandana to the members.
- The trading activity transferred to SpMBT generated surpluses and SpMBT would have to eventually deal with these surpluses.
- If eventually all investments were to come from Spandana as was indicated in the future plans, then the establishment of SpMBT could have been totally avoided.
- It would have been useful to get the senior clients to directly invest in SSIFSL instead of routing it through the SpMBT. This would have given the clients a stake and some could have shared profits. The stake of these clients would not have been significant enough to dictate the governance structure of SSIFSL.

However, if the structure as planned remained stable, then the only cause for concern was how they would maintain both capital adequacy as well as the management control of the promoters. If eventually the promoters were expected to lose control, then the legitimate question was whether the organisation would continue to remain faithful of its mission of serving the underprivileged customers.

Regulatory Issues

The regulatory issues of significance that came out of this case study hinged on three matters:

- How to harness public investments in a larger developmental cause of making financial services available to the underprivileged and build natural incentives for entrepreneurs to work in microfinance. Would generating private profits using a multiplier of the public investments be justified? In many cases we saw that there were public investments that generated large private benefits, but the State still went ahead with these investments through various mechanisms of equity support, subsidies, tax breaks and other forms of support because it believed that the very existence of the firm (irrespective of its motive) would benefit the society at large. Institutions like Spandana were to be seen in this light. If that were the case, we had to ensure that funds available with Spandana could be honourably invested in SSIFSL without resorting to the intermediary means of SpMBT. From the description it was clear that this option of SpMBT was not a desirable, but as there were no alternatives, Spandana was forced to take this route.

- The second issue that came out is the bar on institutions other than banks accepting savings. The only way in which poor could save with formal institutions was to form co-operatives. (Spandana even considered promoting a cooperative exclusively collecting savings, but shelved the idea because of the complications involved). It was worth examining the following options:
    - Accredited MFIs act as agents to the banks.
    - Allow MFIs to collect limited savings products from the registered clients subject to stringent conditions of link with loan limits, capital adequacy of the organisation and liquidity constraints on application of deposits.

  The need for savings was not because of the need for inexpensive funds, but it was demand driven – the poor wanted these facilities.
- How to make way for entrepreneurs with limited capital to start a finance business targeted at the poor, and grow aggressively with it. Spandana proved in a limited time that there was a huge potential for formal institutions to get into the financial market. Spandana worked only in a few districts. This demonstrated the potential. Even if for a moment we kept savings aside, there was space for institutions to lend, and charge reasonable rates of interest. The regulatory environment did not foster entrepreneurs with limited resources to start small and grow aggressively. In cases like Spandana all resources were raised from institutional sources, and there was not even a risk in dealing with the public at large. This case can be used as an illustration of making entry norms simpler for at least pure loan MFIs.

Issues for Replication

The major issues for scaling up and replication that came out of Spandana was about the fragility of the governance structure. The fact that Spandana operated with a small close knit board of well meaning local people with limited professional competence could not be wished away. The effect of weak governance was that they had to experiment not only on product delivery and marketing of its offerings at the operational level, but also had to experiment on organisational design and took several measures for mid-course correction. This was enough to illustrate the fragility of governance. The design of Spandana did not throw up the need for professional governance. If the need for professional governance had indeed emerged, it was largely in response to the observations made by the rating reports and the pressures put by the institutional lenders. Our premise is that if these inputs were available at the initial stages, Spandana would have had a better strategic efficiency.

The debate of getting in additional funding for ensuring capital adequacy for growth was not adequately addressed in Spandana. One possibility was to consider differential voting rights and getting more permanent subordinate capital. While Spandana examined the issue of putting in subordinated debt from its own resources (in the event of law not permitting equity investments) they could also have sought subordinated funds from investors.

Spandana did not look at venture funds as a source of funding very seriously, though there were some venture funds keen to invest. One of the fears of Spandana was that the promoters would lose control over a period of time. However this could have been addressed by differential voting rights and embedding veto rights in the governance structure, so that capital could be brought in, as and when expansion happened.

From the study it appeared that Spandana may be a difficult experiment to replicate, though the basic design elements could still be considered. It was not as complicated as Sarvodaya and was a welcome case for examination of the issues raised in this study.

Sir Ratan Tata Trust Fund for Research Collaborations in Micro finance

Micro finance has been widely acknowledged as a tool for mobilising the poor and reaching quality financial services. The field, especially in India, has developed largely based on practitioner experience. While the sector has expanded, largely through replication, over the past few years, there has also been an increased realisation on limitations of micro finance. The Sir Ratan Tata Trust Fund for Research Collaborations in Micro finance at Indian Institute of Management Ahmedabad (IIMA) supports cutting-edge, field-based research, which reviews and guides experience, especially in the Indian context. The project envisages work on diverse themes such as:

- Understanding financial flows of the poor over long horizons
- Understanding financial flows of seasonal migrants
- Documentation of transformation experiences of Indian microfinance institutions
- Documentation of the role of mainstream banks in microfinance.

Research in progress is put out as working papers. Completed research would be published as papers and books. In addition there would be dissemination through focussed workshops and training programmes for the practitioners.

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